Osterman v. Commissioner, 50 T. C. 970 (1968)

For a lump-sum distribution from an exempt employees' pension trust to qualify for capital gains treatment, it must be made 'on account of' the employee's 'separation from the service. '

Summary

Maurice Osterman purchased the stock of his employer, Charles S. Jacobowitz Corp. , in 1958 and continued working there with increased responsibilities. The corporation had an exempt pension trust in which Osterman participated. After changes in the business and a reduction in employees, Osterman received a lump-sum distribution of his interest in the trust in 1962. The U. S. Tax Court held that Osterman failed to prove the distribution was made 'on account of' his 'separation from the service' as required by section 402(a)(2) of the Internal Revenue Code of 1954. Therefore, he was not entitled to capital gains treatment on the distribution.

Facts

In 1958, Maurice Osterman purchased all the outstanding stock of Charles S. Jacobowitz Corp. (Jaco), becoming its sole shareholder, president, and general manager. Before the purchase, Jaco maintained an exempt pension trust under section 501(a) in which Osterman was a participant. After the purchase, Jaco continued to make contributions to the trust, but the business underwent changes, including a gradual reduction in employees from 30 in 1958 to 12 in 1962. In 1962, Osterman received a lump-sum distribution of his entire interest in the trust. The trust was terminated in 1963.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Osterman's income tax for 1961 and 1962. Osterman petitioned the U. S. Tax Court, arguing that the 1962 distribution should be treated as a long-term capital gain under section 402(a)(2). The Tax Court reviewed the case and ruled against Osterman, finding that he failed to prove the distribution was made 'on account of' his separation from service.

Issue(s)

1. Whether the lump-sum distribution received by Maurice Osterman from the exempt employees' pension trust in 1962 was made 'on account of' his 'separation from the service' within the meaning of section 402(a)(2) of the Internal Revenue Code of 1954?

Holding

1. No, because Osterman failed to establish a sufficiently definite causal relationship

between the changes in the business and the distribution to him in 1962, as required to prove the distribution was made ‘on account of’ his separation from service.

Court’s Reasoning

The court focused on the requirement of section 402(a)(2) that a distribution must be made ‘on account of’ the employee’s ‘separation from the service’ to qualify for capital gains treatment. The court noted that a change in ownership or business alone does not constitute a separation from service, citing cases like *United States v. Johnson* and *United States v. Martin*. The court distinguished this case from *Greenwald v. Commissioner*, where a more radical change in the business occurred. The gradual reduction in employees and the timing of distributions over several years led the court to conclude that Osterman did not prove the distribution was due to a ‘separation from service. ‘ The court emphasized the lack of a clear causal link between the business changes and the distribution, as required by precedents such as *E. N. Funkhouser*.

Practical Implications

This decision underscores the importance of establishing a clear connection between a distribution from an exempt pension trust and an employee’s separation from service to qualify for capital gains treatment. Attorneys advising clients on pension plan distributions must carefully document the reasons for the distribution and any changes in employment status. The ruling may affect how businesses structure pension plan terminations and distributions, ensuring they align with the ‘on account of’ requirement. Subsequent cases have continued to apply this principle, requiring a direct link between the distribution and the employee’s departure from the company.

